Combined Apportionable Income
Partnerships

IT 99-12
Tax Type: Income Tax
Issue: 1005 Penalty (Reasonable Cause Issues)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE	)	Docket No.	97-IT-0000
OF THE STATE OF ILLINOIS	)	FEIN	00-0000000
v.	)	Tax Years Ending	12/92-12/94
"LDS CORPORATION",	)	John E. White,	
Taxpayer.	)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: Fred Marcus and David Hughes appeared for "LDS Corporation"; Deborah Mayer appeared for the Department of Revenue.

Synopsis:

This matter involves "LDS Corporation's" ("LDS") protest of a Notice of Deficiency ("NOD") the Illinois Department of Revenue ("Department") issued to "LDS" regarding its 1992 through 1994 tax years. "LDS's protest challenged, among other things, the validity of what was formerly known as Department income tax rule 100.3700(d). That rule was adopted and made effective July 8, 1987 (86 Ill. Admin. Code § 100.3700(d); 11 Ill. Reg. 12410, 12412 (July 24, 1987)), and is currently published at 86 Ill. Admin. Code § 100.3380(c). Both parties filed Cross Motions for Partial Summary Judgement regarding the validity of that rule. By order dated 6/25/99, the parties notified the administrative law judge that they had settled all issues but for the issue confronted by their cross-motions for summary judgment.

I am including in this recommendation a statement of the undisputed facts

material to the parties' cross motions for partial summary judgment. I recommend that summary judgment be entered for the Department and denied to "LDS".

Facts Not in Dispute:

Facts Regarding "LDS's" Business:

1. "LDS" is a "Someplace USA" corporation licensed to conduct business in Illinois. Separate Statement of Undisputed Material Facts in Support of Motion for Partial Summary Judgment ("LDS's" Facts"), ¶ 1; Department's Memorandum in Support of Its Cross-Motion for Partial Summary Judgment and In Opposition to Taxpayer's Motion for [Partial] Summary Judgment ("Department's Cross-Motion"), p. 3.

2. Divisions of "LDS", and companies affiliated with "LDS", operated in the United States and in at least 79 other countries. "LDS's" Facts, ¶ 2; Department's Cross-Motion, p. 3.

3. "LDS's" principal business is energy, and that business includes exploration for and production of crude oil and natural gas, manufacturing petroleum products, as well as the transportation and sale of crude oil, natural gas and petroleum products. "LDS's" Facts, ¶ 3; Department's Cross-Motion, p. 3.

4. During tax years 1992 through 1994, "LDS", directly or indirectly through certain of its affiliates and subsidiaries, was the owner of interests in certain partnerships (hereinafter "partnerships") which engaged in the exploration for and production of crude oil and natural gas. "LDS's" Facts, ¶ 4; Department's Cross-Motion, p. 4.

5. None of the exploration and production activities conducted by the partnerships

during 1992-1994 were conducted in Illinois. "LDS's" Facts, ¶ 5; Department's Cross-Motion, p. 3. The exploration and production activities were conducted within the water's edge of the United States. *See* Department's Cross-Motion, p. 4 (citing to "LDS's" 1992 Annual Report, pp. 10-11; "LDS's" 1993 Annual Report, pp. 11-12, and to "LDS's" 1994 Annual Reports, pp. 11-12, which reports were attached as parts of exhibits 1-3, respectively, to the Department's Cross Motion).

6. At least one of the owners of the interests in the partnerships is a party unrelated to "LDS" and/or its subsidiaries and affiliates. "LDS's" Facts, ¶ 7.

7. For the years at issue, "LDS" and the partnerships were engaged in a unitary business. "LDS's" Facts, ¶ 8; Department's Cross-Motion, p. 4.

Facts Regarding "LDS's" Illinois Income Tax Returns as Filed, and the Bases for the Department's Corrections of Those Returns:

8. "LDS" timely filed combined Illinois income tax returns for tax years 1992 through 1994. "LDS's" Facts, ¶ 9; Department's Cross-Motion, p. 4, & Exs. 4-6 thereto.

9. On the combined Illinois returns it filed for those years, "LDS" did not include its distributive share of partnership income in its Illinois combined apportionable income, nor did it include its share of partnership apportionment factors in the denominators of the payroll, property and sales factors of its Illinois combined apportionment formula. "LDS's" Facts, ¶ 9; Department's Cross-Motion, pp. 4-5 & Exs. 4-6 thereto.

10. For the tax years at issue, "LDS" did not allocate or apportion any portion of its distributive share of the income from the partnerships in its Illinois combined apportionable income because none of that partnership income had been allocated

or apportioned to Illinois by the partnerships. *See* "LDS's" Facts, ¶ 10; Department's Cross-Motion, pp. 4-5.

11. The Department conducted an audit of "LDS's" business for tax years 1992 through 1994, following which "LDS" protested the NOD the Department issued. That NOD proposed to assess tax and interest in the following amount, and regarding the following period:

Date of NOD	Tax Period	Tax	Interest	TOTAL
10/31/96	12/92 – 12/94	$ 1,549,204	$ 352,820	$ 1,902,024

"LDS's" Facts, ¶ 11; Department's Cross-Motion, pp. 4-5 & Ex. 8 thereto.

12. The tax proposed in the NOD issued against "LDS" was calculated by the Department auditor's use of the combined apportionment method described in § 304(e) of the IITA, and in rule 3700(d). "LDS's" Facts, ¶ 12; Department's Cross-Motion, p. 5 & Ex. 8 thereto.

Conclusions of Law:

The parties' respective Motions for Partial Summary Judgment both addressed the validity of a 1987 amendment to the Department's income tax regulations. The same parties previously filed Motions for Partial Summary Judgment on the identical issue in a matter involving a Department audit of "LDS's" business for tax years 1988 through 1991. "LDS's" Motion for Partial Summary Judgment regarding the same issue was denied by order dated June 22, 1998, entered in the matter docketed as 94-IT-0053 within the Department's Office of Administrative Hearings. Because the issue here is identical to the issue between the same parties in that prior proceeding, I am incorporating by reference the conclusions of law previously set forth in that 6/22/98 order as the bases for denying summary judgment to "LDS", and granting summary judgment to the

Department, in this matter.[1]

To briefly summarize those conclusions, judgment was denied to "LDS" because rule 3700(d) is a reasonable interpretation of §§ 304 and 1501(a)(27) of the IITA. *See* 6/13/98 order, pp. 8, 12-13, 17. Rule 3700(d) was always intended to interpret and administer § 304(e)'s requirement that non-residents who conduct a unitary business use the combined apportionment method when filing their Illinois income tax returns. 35 **ILCS** 5/304(e), 5/1401. In ¶ 4 of the Notice of Adopted Amendments published in the Illinois Register regarding the Department's adoption of rule 3700(d), the Department identified IITA §§ 304(e), 304(f) and 1401(a) as the statutory provisions authorizing the rule. 87 Ill. Reg. 12410 (¶ 4) (July 24, 1987). The rule facilitated the proper administration of § 304(e) by directing certain non-residents, i.e., non-residents that conducted business within a unitary business group that included partnerships as members, and where the activities of the partnerships were conducted outside Illinois but within the water's edge, to report the pro rata shares of income and expenses from such partnerships on their Illinois combined income tax returns.

Promulgation of rule 3700(d) was also the proper and necessary means of announcing the Department's changed interpretation of "common ownership," as that term is used in § 1501(a)(28) of the IITA (*now* 35 **ILCS** 5/1501(a)(27) (defining the term "unitary business group")). *See* Caterpillar Tractor Company v. Lenkos, 84 Ill. 2d 102, 121 (1981) ("it is clear that the use of combined or unitary apportionment method is authorized under the [IITA] and [can] be required by the Department in the case of unitary business groups."). It was the proper way to notify the public of the

[1] A copy of that 6/22/98 order will be appended to and made part of this recommendation.

Department's changed interpretation of "common ownership" because the Director was announcing a rule that affected an entire class of Illinois taxpayers — i.e., all non-residents who conducted business within a unitary group and whose unitary businesses included partnerships as members. 35 **ILCS** 5/1401; 5 **ILCS** 100/5-35 – 5-40 (*formerly* Ill. Rev. Stat. ch. 127, ¶¶ 1005-35 to -40 (1987)). It was necessary because the Department was fundamentally changing the way it had previously interpreted that same term as it applied to the circumstances under which a unitary business group may be composed of corporations and partnerships. *See* 87 Ill. Reg. 12412 (¶ 15) (July 24, 1987) (repealing former income tax rule 100.9900(e)(2)).

For the years at issue, "LDS" concedes that it and the partnerships were engaged in a unitary business. "LDS's" Facts, ¶ 8. Since the oil exploration and production businesses conducted by the partnerships here were concededly part of "LDS's" unitary business, "LDS", the reporting member of that unitary business group, was required to report the income it received from those partnerships as part of its combined unitary base income, pursuant to Illinois' method of combined water's edge apportionment. 35 **ILCS** 5/304(e), General Telephone Co. of Illinois v. Johnson, 103 Ill. 2d 363, 370-71 (1984); Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d at 102, 108-09 (1981); A.B. Dick Co. v McGaw, 287 Ill. App. 3d 230, 237-38 (4th Dist. 1997); 86 Ill. Admin. Code § 100.3700(d) (1987) (*now* 86 Ill. Admin. Code 100.3380(c)).

For the reasons more fully articulated in the attached 6/22/98 order, I recommend that judgment be entered for the Department, and against "LDS". Therefore, the tax proposed to be assessed in the NOD should be revised consistent with the parties' 6/25/99

agreed order, then finalized and assessed pursuant to statute.

9/7/99
Date

John E. White

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE	)	Docket No.	94-IT-0053
OF THE STATE OF ILLINOIS	)	FEIN	13-5409005
v.	)	Tax Years Ending	12/88-12/91
"LDS" CORPORATION,	)	John E. White,	
Taxpayer.	)	Administrative Law Judge	

RECOMMENDATION REGARDING "LDS's" MOTION FOR PARTIAL SUMMARY JUDGMENT

This matter involves two Notices of Deficiency ("NOD's") the Illinois Department of Revenue issued to "LDS" Corporation ("LDS" or "taxpayer") regarding "LDS's" 1988 through 1991 tax years. "LDS" protested those NOD's, and requested hearings thereon. The instant matter involves "LDS's" Motion for Partial Summary Judgment ("LDS's" Motion"). "LDS's" Motion challenges the validity of Illinois Department of Revenue ("Department") rule 100.3700(d), which was adopted and made effective July 8, 1987. 86 Ill. Admin. Code § 100.3700(d); 11 Ill. Reg. 12410, 12412 (July 24, 1987) (*now* 86 Ill. Admin. Code § 100.3380(c); 17 Ill. Reg. 19632 (November 1, 1993)). "LDS's" Motion challenges the validity of income tax rule 3700(d) as being contrary to sections 305, 1501(a)(18) and 1501(a)(27) of the Illinois Income Tax Act ("IITA").

"LDS's" Motion was fully briefed and oral argument presented by counsel for both parties. I am including within this recommendation a statement of material facts not in dispute, as well as conclusions of law. I recommend that "LDS's" Motion be denied, and that this matter proceed to hearing, forthwith.

Facts Not in Dispute:

Facts Regarding "LDS's" Business:

13. "LDS" is a "Someplace USA" corporation licensed to do conduct business in Illinois. "LDS's" Separate Statement of Undisputed Material Facts in Support of Motion for Partial Summary Judgment ("LDS's" Facts"), ¶ 1; Department's Response to Taxpayer's Motion for Partial Summary Judgment ("Department's Response"), p. 1.

14. Divisions of "LDS", and companies affiliated with "LDS", operated in the United States and in at least 79 other countries. "LDS's" Facts, ¶ 2; Memorandum in Support of the Department's Response to Taxpayer's Motion for Partial Summary Judgment ("Department's Memo"), p. 2 & exhibits 1-4 thereof (p. 1 of each exhibit). (Department's Memo exhibits 1 through 4 consist of, respectively, "LDS's" annual reports for 1988 through 1991)

15. "LDS's" principal business is energy, and that business includes exploration for and production of crude oil and natural gas, manufacturing petroleum products, as well as the transportation and sale of crude oil, natural gas and petroleum products. "LDS's" Facts, ¶ 3; Department's Response, p. 1.

16. During tax years 1988 through 1991, "LDS", directly or indirectly through certain of its affiliates and subsidiaries, was the owner of interests in certain tax partnerships (hereinafter "partnerships") which engaged in the exploration for and production of crude oil and natural gas. "LDS's" Facts, ¶ 4; Department's Response, p. 1.

17. None of the exploration and production activities conducted by the partnerships

during 1988-1991 were conducted in Illinois. "LDS's" Facts, ¶ 5; Department's Response, p. 1.

18. At least one of the owners of the interests in the partnerships is a party unrelated to "LDS" and/or its subsidiaries and affiliates. "LDS's" Facts, ¶ 7; Department's Response, p. 1.

19. For purposes of this matter, "LDS" concedes that the activities of "LDS" and the activities of the partnerships constituted a unitary business. "LDS's" Facts, ¶ 8; Department's Response, p. 1.

Facts Regarding "LDS's" Illinois Income Tax Returns as Filed, and the Department's Corrections Thereof:

20. "LDS" timely filed combined Illinois income tax returns for tax years 1988-91. "LDS's" Facts, ¶ 9; Department's Response, p. 1.

21. On the combined Illinois returns it filed for 1988-91, "LDS" did not include its distributive share of partnership income in its Illinois combined apportionable income, nor did it include its share of partnership apportionment factors in the denominators of the payroll, property and sales factors of its Illinois combined apportionment formula. "LDS's" Facts, ¶ 9; Department's Response, p. 1.

22. "LDS" did not allocate or apportion any portion of its distributive share of the income from the partnerships in its Illinois combined apportionable income because none of that partnership income had been allocated or apportioned to Illinois by the partnerships. "LDS's" Facts, ¶¶ 6, 10; Department's Response, p. 1.

23. The Department conducted an audit of "LDS's" business for tax years 1988-1991, following which the two NOD's protested here were issued. Those NOD's

proposed to assess tax and penalties in the following amounts, and for the following periods:

Date of NOD	Tax Period	Tax	Penalty	TOTAL
11/19/93	12/88 – 12/89	$ 1,628,506	$ 442,353	$ 2,070,859
4/22/94	12/90 – 12/91	$ 1,008,358	$ 153,423	$ 1,161,781
TOTAL		$ 2,636,864	$ 595,776	$ 3,232,640

"LDS's" Facts, ¶¶ 11; Department's Response, p. 1.

24. The tax proposed in the NOD's issued against "LDS" was calculated by the Department auditor's use of the combined apportionment method described in § 304(e) of the IITA, and in Department income tax rule 100.3700(d). "LDS's" Facts, ¶¶ 12-15; Department's Response, p. 1.

25. The Department made the following adjustments to the following amounts reported by "LDS" on its combined returns:

Tax Year	Increased "LDS's" Combined Apportionable Income	Increased Denominator of "LDS's" Combined Sales Factor	Increased Denominator of "LDS's" Combined Property Factor
12/31/88	$ 1,114,473,926	$ 1,241,421,732	$ 4,090,090,454
12/31/89	$ 1,216,764,298	$ 1,614,577,726	$ 4,979,682,363
12/31/90	$ 1,281,526,924	$ 1,889,051,850	$ 5,236,018,084
12/31/91	$ 947,179,776	$ 1,438,356,898	$ 5,233,896,236

"LDS's" Facts, ¶¶ 12-15; Department's Response, p. 1.

26. The amounts the Department added to "LDS's" combined apportionable income equaled "LDS's" distributive share of income from the partnerships with whom "LDS" conducted a unitary business. "LDS's" Facts, ¶¶ 9, 12-13; Department's Response, p. 1.

27. The amounts the Department added to the denominator of "LDS's" combined sales factor equaled gross receipts from partnership sales outside Illinois. "LDS's" Facts, ¶¶ 9, 12, 14; Department's Response, p. 1.

28. The amounts the Department added to the denominator of "LDS's" combined property factor equaled gross receipts attributable to partnership property outside Illinois. "LDS's" Facts, ¶¶ 9, 12, 15; Department's Response, p. 1.

Conclusions of Law:

"LDS's" Motion argues that "the Department's adoption and application of Regulation Section 100.3700(d) to a partnership engaged in a unitary business with one of its partners is contrary to Act Sections 305, 1501(a)(18) and 1501(a)(27) and, therefore, is invalid." "LDS's" Memo, p. 2; *see also* "LDS's" Motion, p. 1. The Department responds that the "issue is not whether a 10 year old regulation, promulgated after an extended rule-making process, is not valid, as argued by the Taxpayer, but whether Regulation 3700(d) is a reasonable interpretation of Section 305 and the unitary principles of the IITA." Department's Memo, p. 2.

Pursuant to § 1401 of the IITA, the Department is "authorized to make, promulgate and enforce such reasonable rules and regulations ... relating to the administration and enforcement of the provisions of [the IITA], as it may deem appropriate." 35 **ILCS** 5/1401(a). The Department's power to issue regulations relating to the IITA is the same authority the Department has been granted pursuant to other tax acts it administers. *See, e.g.*, 35 **ILCS** 120/12 (*formerly* Ill. Rev. Stat. ch. 120, ¶ 451 (1953) (the Retailers' Occupation Tax Act ("ROTA")); Pressed Steel Car Co. v. Lyons, 7 Ill. 2d 95, 106 (1955).

The Illinois supreme court has considered the scope and nature of the General Assembly's grant of rule making authority to the Department. In Du-Mont Ventilating Co. v. Department of Revenue, 73 Ill. 2d 243, 244-45 (1978), for example, the Illinois supreme court wrote,

> The enabling legislation ... authorizes the Department to make, promulgate and enforce reasonable rules and regulations relating to the administration and enforcement of the [ROTA]. The rule merely interprets the scope of the statutory exemption provision and as such it is entitled to some respect as an administrative interpretation of the statute, but it is not binding on the courts. See *Oscar L. Paris Co. v. Lyons*, (1956), 8 Ill. 2d 590, 597-98; *Terrace Carpet Co. v. Department of Revenue*, (1977), 46 Ill. App. 3d 84, 90.
>
> Administrative rules can neither limit nor extend the scope of a statute. . . .

Du-Mont Ventilating Co., 73 Ill. 2d at 247. Although the ultimate arbiter of an agency's interpretation of Illinois law must be an Illinois court, income tax rule 3700(d) will be upheld *only if it is* a "reasonable rule[] ... relating to the administration and enforcement of the provisions of [the IITA]." 35 **ILCS** 5/1401(a); *see also* Texaco-Cities Services Pipeline Co. v. McGaw, No. 82988, slip op. p. 8 (Illinois Supreme Court, April 16, 1998) (while not binding on the court, Department's income tax regulations interpreting the IITA's definition of business income were given "substantial deference"); Dover v. Illinois Department of Revenue, 271 Ill. App. 3d 700, 707-08 (1st Dist 1995) (Department's regulation interpreting IITA was valid when read in conjunction with the Illinois supreme court's decision in GTE Automatic Electric v. Allphin, 68 Ill. 2d 326 (1977)).

Effective July 8, 1987, rule 3700(d) provided as follows:

> (d) Rule for inclusion of shares of partnership unitary

> business income and factors in combined unitary business income and factors of corporate partners.
>
> When the activities of a corporate partner (or the activities of a unitary business group including the corporate partner) and the activities of a partnership, disregarding ownership requirements, constitute a unitary business relationship, then the partner's share of the partnership's income and factors shall be combined with the business income and factors of the partner or with the combined business income and factors of the unitary business group including the partner, as the case may be. The activities of a corporate partner and the activities of a partnership will constitute a unitary business relationship when such activities are integrated with, dependent upon, and contribute to each other. However, the rule stated herein will not apply to shares of income from partnerships whose business activity outside the United States is 80% or more of such partnership's total business activity, where the partnership has a different apportionment method than the corporate partner, or where the partnership is not in the same general line of business or a step in a vertically structured enterprise with the corporate partner. This rule is applicable to all taxable years for which the statute of limitations for filing claims for refund and for issuing notices of deficiency are open, except those tax years ending on or after the effective date (April 24, 1984) of Section 100.9700(e)(2) and ending prior to its repeal where the taxpayer relied upon that rule.

86 Ill. Admin. Code § 100.3700(d), 11 Ill. Reg. 12410, 12421.

That is not the way the rule was written when first proposed. Before rule 3700(d) was adopted, the Joint Committee on Administrative Rules ("JCAR") filed a statement of objections to the original version of the rule. 11 Ill. Reg. 7462-72 (April 17, 1987) (JCAR's Statement of Objection) (JCAR's objections are attached as Exhibit A to "LDS's" Memo); *see also* Ill. Rev. Stat. ch. 127, ¶ 1007.06 (1987).[2]

[2] Section 7.06 of the Illinois Administrative Procedures Act ("IAPA") details the duties and responsibilities of JCAR regarding objections to proposed, amended or repealed rules, as well as the duties and responsibilities of the affected agency to respond to JCAR's objections. Ill. Rev. Stat. ch. 127, ¶ 1007.06 (1987). The Department's response to JCAR's objections was submitted

When finally adopted by the Department, rule 3700(d) had been modified, in part, by adding the second and third sentences "[p]er agreement with JCAR". 11 Ill. Reg. 12411 (¶ 11). In paragraph 11 of the Department's Notice of Adopted Amendment, the Department identified all the modifications to the original version of rule 3700(d). 11 Ill. Reg. 12410-11 (¶ 11 of that Notice is titled: "Differences between proposal and final version [of rule]"). In paragraph 12 of its Notice of Adopted Amendment, the Department replied "Yes" to the question: "Have all the changes agreed upon by the agency and JCAR been made as indicated in the agreement letter issued by JCAR?" 11 Ill. Reg. 12411 (¶ 12).

Subsection (d) of income tax rule 3700 was a brand new rule, and it was situated within a section of regulations the Department had previously promulgated to articulate special rules interpreting the provisions of 304 of the IITA. 11 Ill. Reg. 12410 (in ¶ 4 of the Department's Notice of Adopted Amendments, the Department identified IITA §§ 304(e), 304(f), and 1401(a) as the statutory authority for the new rule). Section 304 describes how non-residents are to allocate and/or apportion business income. Section 304 provides, in relevant part:

> Business income of persons other than residents.
> (a) In general. The business income of a person other than a resident shall be allocated to this State if such person's business income is derived solely from this State. If a person other than a resident derives business income from this State and one or more other states, then, except as otherwise provided by this Section, such person's business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any) and 200% of the sales factor (if any), and the denominator of which is 4 reduced by the number of factors other than the

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to JCAR on June 25, 1987 (*see* 11 Ill. Reg. 12410, ¶ 10(C)), and published at 11 Ill. Reg. 12473.

> sales factor which have a denominator of zero and by an additional 2 if the sales factor has a denominator of zero.
>
> * * *
>
> **(e) Combined apportionment. Where 2 or more persons are engaged in a unitary business as described in subsection (a)(27) of Section 1501, a part of which is conducted in this State by one or more members of the group, the business income attributable to this State by any such member or members shall be apportioned by means of the combined apportionment method.**
>
> (f) Alternative allocation. If the allocation and apportionment provisions of subsections (a) through (e) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:
>
> (1) Separate accounting;
> (2) The exclusion of any one or more factors;
> (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

35 **ILCS** 5/304 (*formerly* Ill. Rev. Stat. ch. 120, ¶ 2-304 (1987)) (emphasis added).

As "LDS" described in its Motion and Memo, the Department's adoption of rule 3700(d) represented a marked departure from the Department's prior interpretations of the IITA's provisions regarding combined reporting and partnerships. *See e.g.*, "LDS's" Facts, pp. 5-6 (¶¶ 18-21); "LDS's" Memo, pp. 4, 15-18 & exhibit A thereto. Prior to that time, the Department had interpreted IITA section 1501(a)(28) — the statutory definition of "unitary business group" — to mean that a partnership could be combined into a unitary business group with a corporation which was a partner in the partnership only if each and every partner in the partnership was also a member of the unitary business group. That "all or nothing" rule was set forth in income tax rule 9900(e)(2)(i), which the Department promulgated in 1984.

Income tax rule 9900 provided definitions and illustrations of terms used by the Illinois General Assembly in its definition of the term "unitary business group." Ill. Rev. Stat. ch. 120, ¶ 2-1501(a)(28) (1987). Subsection (e) of that rule interpreted the term "common ownership", and subsection (e)(2) interpreted common ownership as it pertained to partnerships. 86 Ill. Admin. Code § 100.9900(e)(2). Specifically, former income tax rule 9900(e)(2) provided:

> Partnerships.
> Under IITA Section 1501(a)(16), a partnership is defined to include joint ventures. For clarity, the rules which follow deal separately with partnerships and joint ventures, though the underlying principles enunciated in the rules for the two types of enterprise are the same. **The rules stated below only address whether a partnership is "related through common ownership" to other persons in a group.** Even if it is so related, it will only be a member of such group if it meets the other relevant tests.
> A) it employs the same apportionment method as other members,
> B) it has more than 20% of its business activity in the U.S.,
> C) it is under strong centralized management with other members, and
> D) it is in the same general line of business as other members or it is a step in a vertically structured enterprise with other members.
> i) Traditional Partnerships.
> A partnership cannot be a member of a unitary business group unless it is "related through common ownership" to other members of the group. IITA Section 1501(a)(28) does not provide a mathematical test for common ownership of partnerships as it does for corporations. (See paragraph subsection (e)(1) above.) These regulations proceed from the premise that the partners are owners of the partnership. **Consequently, a partnership is related through common ownership if the group includes all of its partners. If a group of persons includes some, but not all, of a partnership's partners, the partnership will not generally be deemed to be related to the group through common ownership.** . . .

86 Ill. Admin. Code § 100.9900(e)(2) (emphasis added). The last sentences emphasized above set forth the "all or nothing" rule repealed when rule 3700(d) was adopted. 11 Ill. Reg. 12410-12 (¶¶ 3, 15).

Before rule 3700(d) was adopted, and while purporting to allow combination of corporations and partnerships into a unitary business group (*see* 86 Ill. Admin. Code § 100.9900(b)), the Department had interpreted the concept of common ownership in such a way as to virtually assure that no such combinations would ever occur. Ill. Rev. Stat. ch. 120, ¶ 2-1501(a)(28) (*now* 35 **ILCS** 5/105(a)(27)). Interestingly, the Department articulated three exceptions to the all or nothing rule, which exceptions would "not preclude" the combination of a corporation and a partnership into a unitary business group. *See* 86 Ill. Admin. Code § 100.9900(e)(2)(i). However, in practice, those exceptions required that someone undertake an extensive examination of the partnership agreements themselves, including an analysis of whether partners named in those partnership agreements (and who did not share common ownership with the corporation) enjoyed the "*usual* rights … to participate in the conduct and control of the partnership business," or whether the general partners to such partnerships had any "*real independent* interest in the management or control of the partnership business …." *Id.* (emphasis added).[3] In other words, even the exceptions to the general rule made it difficult to combine into a unitary business group persons clearly engaged in a unitary business enterprise, simply because the members, or partners, had different forms of business ownership.

[3] There was no hint in former rule 9900(e)(2)(i) how these vague standards might be implemented.

The Department's former "all or nothing" rule made it easy to manipulate combined reporting, merely by including an individual as one of the named partners in a partnership agreement.[4] Even assuming the Department's premise that a partnership is owned by its partners was relevant within the context of combined apportionment (*see* 86 Ill. Admin Code § 100.9900(e)(2)(i)),[5] no individual partner could *ever* be "related through common ownership" with a corporation with whom it entered into a partnership agreement.

I cannot agree with "LDS's" argument that rule 3700(d) disregards IITA § 1501(a)(27)'s common ownership requirement. *See* "LDS's" Memo, pp. 25-26. What rule 3700(d) really disregards is the Department's former "all or nothing" interpretation of common ownership, and not the General Assembly's requirement that members of the group be related through common ownership. Under a fair reading of the rule, the corporation would share common ownership with a partnership if the corporation owns an interest in the partnership, and where such interest and operations are consistent with the other requirements for unitary combination, e.g., the partnership and the corporate partner are engaged in the same or similar general lines of business, or both constitute

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[4] I do not mean to suggest that that is what occurred here. I make the point only to stress how unworkable in practice was the Department's former interpretation of the common ownership necessary before a corporation and a partnership could be considered to be engaged in a unitary business.

[5] Illinois' Uniform Partnership Act has always provided that a "partner's interest in the partnership is his share in the profits and surplus" of the business being conducted by the partnership. Ill. Rev. Stat. ch. 106½, ¶ 26 (1917) (*now* 805 **ILCS** 205/26); In re Estate of Johnson, 129 Ill. App. 3d 22, 27 (4th Dist. 1985). So, while it might be said that the partners *own* the partnership, what each partner actually owns is an expectancy interest in the contractual (partnership) arrangement, rather than the contract itself. 805 **ILCS** 205/26.

steps in a vertically structured enterprise, etc. *See* 35 **ILCS** 5/1501(a)(27).[6] That understanding of common ownership between a partnership and a corporate partner would require combination where the partnership's activities, in fact, are part of the corporate partner's unitary business activities. That same understanding would also prevent a corporate partner, whose partnership interest was unrelated to, or which was not an integral part of, the corporation's unitary business, from being required to report and apportion its distributive share of income and factors from such a partnership on its Illinois combined returns.

Rule 3700(d)'s repeal of the Department's prior interpretation of "common ownership" as used in § 1501 of the IITA reflected the Department's changed interpretation of § 304, as it pertained to the combined reporting obligations of corporations whose unitary businesses included partnerships as members. It also amended the Department's interpretation of § 1501's definition of a "unitary business group," from one which included an understanding of "common ownership" which turned more on form than substance, to one which instead focused on whether a partnership was, in fact, another member of a non-resident corporation's unitary business — part of which business was being conducted within Illinois and part of which was conducted outside of Illinois, but within the water's edge. 35 **ILCS** 5/304(e), 1501(a)(27).

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6 One of the significant differences between corporations and partnerships, moreover, is that control over a partnership's affairs need not follow majority ownership interests. *See* 59A Am Jur 2d *Partnership* § 15 (1987). Unlike shareholders of a corporation, "[a] partner usually has a right to participate in the conduct and control of the partnership business …." *Id.* Additionally, partners act as mutual agents and fiduciaries for each other. Rizzo v. Rizzo, 3 Ill. 2d 291, 302 (1954). Therefore, § 1501(a)(27)'s express provision that "[c]ommon ownership *in the case of corporations* is the direct or indirect control or ownership of more than 50% of the outstanding voting stock of the persons carrying on the unitary business activity" (*see* 35 **ILCS**

Illinois law requires that members of a unitary business group that are subject to Illinois income tax file returns using combined apportionment. 35 **ILCS** 5/304(e); General Telephone Co. v. Johnson, 103 Ill. 2d 363, 371-72 (1984); A.B. Dick Co. v McGaw, 287 Ill. App. 3d 230, 237 (4th Dist. 1997). Specifically, the court in A.B. Dick recognized that:

> … combined reporting is not an aberration; it is a necessary tool to prevent the triumph of corporate formality over economic reality. *Citizen's Utilities*, 111 Ill. 2d at 40, 488 N.E.2d at 987. ... Neither the Department nor the taxpayer has a choice whether combined returns are filed. If the business is unitary, combined reporting is required. It is important that rules be developed to establish what is and what is not a unitary business. The purpose of section 1501(a)(27) of the Tax Act, as explained in Governor Thompson's message accompanying the amendatory veto which created the section, was to "provide the certainty and the stability so important to businesses, particularly those considering expanding within or into Illinois." [citation omitted]

A.B. Dick Co. v McGaw, 287 Ill. App. 3d at 237-38.

It is important to remember here that what Illinois' scheme of water's edge combined apportionment attempts to "apportion" is the business income of the *entire unitary group*, some of whose members conduct business wholly or partially within Illinois and some of whose members may conduct business wholly outside Illinois. General Telephone Co., 103 Ill. 2d at 371-72. Combined apportionment differs from an apportionment scheme — like the ones expressed by the text of IITA §§ 304(a) and 305(a) — which seeks to apportion only the business income earned by a single entity that conducts business in several states. In General Telephone, the Illinois supreme court

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5/1501(a)(27)), does not mandate a similar (and unexpressed) requirement for combination "in the case of partnerships" and their corporate partners who are engaged in a unitary business.

described how combined apportionment worked:

> First, the business income of each corporate member of the group would be computed so that the total business income of the group could be derived. Then, to determine the apportionment factor for a group member subject to the Illinois income tax, the property, payroll, and sales factors would be computed by using the individual *group member's* Illinois property, payroll, and sales as numerators, and the *entire unitary group's* property, payroll, and sales as denominators. The average of these three factors would be the group member's apportionment factor. This apportionment factor then would be applied to the group's total business income to derive the amount of business income on which the group member would pay Illinois income tax. See *Caterpillar Tractor Co. v. Lenckos* (1979), 77 Ill. App. 3d 90, 98, *aff'd* (1981), 84 Ill. 2d 102.

General Telephone Co., 103 Ill. 2d at 371-72 (emphasis original).

The only difference between combined reporting for unitary groups made up of corporations, and combined reporting for groups made up of corporations and partnerships, is that, in the former case, the entire business income and factors of a corporation which conducts operations wholly outside Illinois would be included, respectively, in the combined unitary business income of the group, and within the entire unitary group's property, payroll and sales factor denominators. *Id.* In the latter case, only the reporting corporate partner's distributive share of partnership business income is included within the group's combined unitary business income, and the partner's respective shares of property, payroll and sales are included within the denominators of the reporting partner's combined apportionment fraction. 35 **ILCS** 5/304(e); 86 Ill. Admin. Code § 100.3700(d). That slight difference is consistent with the IITA's conduit method of taxing partners, and not partnerships, for income tax purposes. Acker v. Department of Revenue, 116 Ill. App. 3d 1080, 1083-84 (1st Dist. 1983).

"LDS's" primary argument is that rule 3700(d) is invalid because it contradicts § 305 of the IITA. *See* "LDS's" Memo, pp. 12-15. "LDS" argues that the contradiction between the two is that § 305(a) requires apportionment at the partnership level, while rule 3700(d) requires apportionment at the partner level. "LDS's" Memo, pp. 13-14. Section 305 provides:

> Allocation of Partnership Income by partnerships and partners other than residents.
> (a) Allocation of partnership business income by partners other than residents. The respective shares of partners other than residents in so much of the business income of the partnership as is allocated or apportioned to this State in the possession of the partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership's taxable year and allocated to this State.
> (b) Allocation of partnership nonbusiness income by partners other than residents. The respective shares of partners other than residents in the items of partnership income and deduction not taken into account in computing the business income of a partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership's taxable year, and allocated as if such items had been paid, incurred or accrued directly to such partners in their separate capacities.
> **(c) Allocation or apportionment of base income by partnership. Base income of a partnership shall be allocated or apportioned to this State pursuant to Article 3, in the same manner as it is allocated or apportioned for any other nonresident.**
> (d) Cross reference. For allocation of partnership income or deductions by residents, see Section 301(a).

35 **ILCS** 5/305 (emphasis added).

"LDS" argues that:

> Act Section 305(a) and Regulation Section 100.3700(d) obviously offer two differing approaches to the taxation of unitary partnerships. Under Act Section

> 305(a), partnerships with no property, payroll or sales in Illinois, such as the partnerships at issue here, apportion all of their business income to states other than Illinois. By contrast, under regulation section 100.3700(d) partnerships with no Illinois property, payroll or sales will nonetheless have some of their income apportioned to Illinois if any one of the partnership's partners is subject to the state's taxing jurisdiction.

"LDS's" Memo, p. 14.

"LDS" is certainly correct when it argues that the text of § 305 contains no unitary business exception. *See* "LDS's" Memo, p. 13. But it is wrong when it suggests that

§ 305(a) offers any type of approach regarding the taxation of a *unitary* partnership. *See* "LDS's" Memo, p. 14. Like § 304(a), the text of § 305(a) does not include the term "combined" apportionment, nor does it use the phrases "unitary," "unitary business" or "unitary partnership." 35 **ILCS** 5/305(a). Instead, § 305(c) directs one to § 304 (the pertinent section within Article 3) for instructions on how to allocate or apportion partnership base income. 35 **ILCS** 5/305(c). Section 304 requires members of a unitary business to use combined reporting to apportion the group's base income. 35 **ILCS** 5/304(e). Section 304 is the statutory provision rule 3700(d) interprets. *See* 11 Ill. Reg. 12410 (¶ 4).

The absence of combined reporting instructions or directions within the text of § 305(a), however, does not evince a legislative intent to preclude a corporation from taking into account, reporting and apportioning its distributive share of income of a partnership, where the partnership itself is a member of the corporate partner's unitary business. In this respect, the Department's 1987 revised interpretation of combined reporting for unitary groups made up of corporations and partnerships is similar, if not

identical, to the Illinois supreme court's interpretation of combined apportionment used by reporting members of corporations engaged in a unitary business, who would otherwise use formula apportionment as described in § 304(a). In General Telephone Co. of Illinois v. Johnson, 103 Ill. 2d at 371, the Illinois supreme court recognized that the text of § 304(a) did not expressly authorize combined apportionment, but it nevertheless concluded that "the use of the combined or unitary apportionment method [was] authorized under the Act *and could be required by the Department* … in the case of unitary business groups." *Id.*, 103 Ill. 2d at 72 (*quoting* Caterpillar Tractor Co. Lenkos, 84 Ill. 2d at 121) (emphasis added).

When writing section 305 of the IITA, the General Assembly intended to set up a conduit or pass-through means of allocating and apportioning a partnership's income, but leaving the partners to fulfill their own taxpaying obligations with regard to satisfying any Illinois income tax due on their distributive shares of such income. The Illinois appellate court, in Acker v. Department of Revenue, 116 Ill. App. 3d 1080 (1st Dist. 1983), addressed § 305 and the Illinois General Assembly's intent behind that provision of the IITA. It wrote:

> . . . A partnership is not a taxpayer. A partnership serves as an entity for the purpose of calculating and filing informational returns and as a conduit through which the taxpaying obligation passes to the individual partners. The fact that a partnership computes base income as if it were an individual cannot, therefore, be construed to mean that it should have the correlative rights of an individual (nonpartner) taxpayer. To treat a partnership in this manner would be in contravention of the Income Tax Act which carefully provides for the allocation of partnership business and nonbusiness income (Ill. Rev. Stat. 1981, ch. 120, pars. 3-305(a), (b)), and it would be contrary to Illinois case law which recognizes a partnership as a contractual relationship of mutual agency which is formed to carry on a business

> purpose of a particular kind. [citations omitted] Similar language portraying this issue is found in *United States v. Basye* (1973), 410 U.S. 441, 35 L. Ed. 2d 412, 93 S. Ct. 1080, where the Supreme Court held that "the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. **Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.**" (410 U.S. 441, 448, 35 L. Ed. 2d 412, 419, 93 S. Ct. 1080, 1085.)

Acker, 116 Ill. App. 3d at 1083-84 (emphasis added).

The "LDS" partnerships here were engaged in the business of exploring for and producing crude oil and natural gas. "LDS's" Facts, ¶ 4; Department's Response, p. 1. The parties agree that those exploration and production operations took place outside Illinois, and they also agree that "LDS" and the partnerships were engaged in a unitary business. "LDS's" Facts, ¶¶ 5, 8; Department's Response, pp. 1-2. "LDS" conducts part of its unitary business within Illinois and part of it outside Illinois. "LDS's" Facts, ¶ 2; Department's Response, p. 1. There is no dispute regarding those key facts. *See* A.B. Dick Co., 287 Ill. App. 3d at 236 (whether a taxpayer participated in a unitary business is a question of fact).

When discussing apportionment of the business income of a unitary business group comprised solely of corporate members, the Illinois appellate court recently noted that:

> It is not an easy question what part of a corporation's income should be taxed in a particular state when that corporation does business in several states. The question is even more complicated when the multistate business is carried on by an associated group of corporate entities. See *Citizens Utilities Co. v. Department of Revenue*, 111 Ill. 2d 32, 39, 488 N.E.2d 984, 986, 94 Ill.

> Dec. 737 (1986); *Caterpillar Tractor Co. v. Lenckos*, 84 Ill. 2d 102, 108, 417 N.E.2d 1343, 1347, 49 Ill. Dec. 329 (1981).

A.B. Dick Co. v. McGaw, 287 Ill. App. 3d at 231. By how much or in what manner did the partnerships' exploration and production activities here contribute to the income "LDS" earned within the water's edge? As Illinois courts have recognized, the answer to that question is difficult to calculate; which is why combined apportionment is required in the first place. General Telephone Co. of Illinois v. Johnson, 103 Ill. 2d at 371 ("When a corporate taxpayer is a member of ... a [unitary business] group ordinary section 304(a) formula apportionment … often does not fairly depict the amount of the unitary business group's income that has resulted from the individual corporate taxpayer's activities within the taxing State. To resolve this problem, combined apportionment [is] employ[ed] …"); A.B. Dick Co. v. McGaw, 287 Ill. App. 3d at 231.

Rule 3700(d) does not contravene § 305(a) because that section is devoid of any direction regarding combined reporting of partnership income. Section 305(a) was written before combined apportionment was approved by the Illinois supreme court, and thereafter revised from world-wide to water's edge combined apportionment by the Illinois General Assembly. I reject, however, the suggestion that § 305(a) does not mean what it says. *See* Tr. p. 38 (argument of Department counsel). By its own terms, § 305(a) contemplates that a partnership might be engaged in a multistate business, and it provides direction regarding how partners are to take into account their distributive shares of income as it was apportioned — in the hands of the partnership — among the states in which the partnership is engaged in business. But it does not address a situation where a partnership is, itself, a member of a unitary business group.

Read together, however, sections 1501 and 304(e) of the IITA do address such a situation. Those sections authorize combination, and combined reporting by corporate partners who are subject to Illinois income tax, in the manner described by rule 3700(d). Moreover, the Illinois supreme court's construction of the IITA to authorize — and require (*see* General Telephone Co. of Illinois v. Johnson, 103 Ill. 2d at 370-72) — combined reporting for members of unitary businesses who are subject to Illinois income tax, is part of the IITA. *See* Union Electric Co. v. Illinois Commerce Comm., 77 Ill. 2d 364, 381 (1977); Kroger Co. v. Department of Revenue, 284 Ill. App. 3d 473, 480 (1st Dist. 1996) ("A court's construction of a statute is considered part of the statute itself, unless and until the legislature amends it contrary to the interpretation."); *see also* Beatrice v. Department of Revenue, 292 Ill. App. 3d 532, 685 N.E.2d 958 (1st Dist. 1997) ("The year after the Illinois Supreme Court decided *Caterpillar*, the Illinois General Assembly added the definition of 'unitary business group' and the concept of combined apportionment to the Illinois Tax Act, but rejected the *Caterpillar* court's concept of 'worldwide combined apportionment.' See Pub. Act 82-1029, eff. December 15, 1982. *We find that, in doing so, the legislature otherwise embraced the Illinois Supreme Court's concept of combined apportionment.*") (emphasis added).

When the General Assembly amended section 1501 of the IITA to include a definition of a unitary business group, it defined the term to include "a group of *persons* related through common ownership whose business activities are integrated with, dependent upon and contribute to each other …." Ill. Rev. Stat. ch. 120, ¶ 2-1501(a)(28) (1987). The legislature's use of the word "persons" shows that the legislature did not intend combined apportionment and reporting to apply only to groups of related

corporations. *See* Ill. Rev. Stat. ch. 120, ¶ 2-1501(a)(18) (1987) (*now* 35 **ILCS** 5/1501(a)(18)). Instead, the General Assembly anticipated that a unitary group might be composed of members having different forms of ownership.

When it promulgated income tax rule 9900(b) in 1984, the Department acknowledged that a unitary business group could be composed of a combination of corporations and partnerships. 86 Ill. Admin. Code § 100.9900(b)(1) (1984). However, until 1987, the Department's interpretation of the term "common ownership" virtually precluded any such combinations from ever taking place. 86 Ill. Admin. Code § 100.9900(e)(2)(i) (1984) (repealed at 11 Ill. Reg. 11410-12 (¶¶ 3, 15)). The Department's 1987 adoption of income tax rule 3700(d), and its contemporaneous repeal of parts of former income tax rule 9900, effected the Department's amendment of its prior interpretation of that term. Those changes also amended the Department's interpretation of the combined reporting requirements of corporations subject to Illinois income tax, whose unitary businesses include partnerships in which the corporation is a partner.

Since the exploration and production businesses conducted by the partnerships here were part of "LDS's" unitary business, "LDS", the reporting member of that unitary business group, was required to report the income it received from those partnerships as part of its combined unitary base income, pursuant to Illinois' method of combined water's edge apportionment. 35 **ILCS** 5/304(e), 305(c); General Telephone Co. of Illinois v. Johnson, 103 Ill. 2d at 370-71; Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d at 108-09; A.B. Dick Co. v McGaw, 287 Ill. App. 3d at 237-38.

I cannot conclude that income tax rule 3700(d) is invalid, or that it sets forth an

unreasonable interpretation of the provisions of sections 304, 305, and 1501 of the IITA. Therefore, "LDS's" Motion is denied.

Date	John E. White